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ANNUAL REPORT

OF

AMERICAN AIRLINES, INC.

YEAR ENDED
DECEMBER 31, 1938

General Office — 4848 West 63rd Street, Chicago, Illinois
Corporate Office — 927 Market Street, Wilmington, Delaware

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AMERICAN AIRLINES, INC.

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C. R. SMITH

Vice Presidents

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REPORT OF THE PRESIDENT

Chicago, Illinois
March 15, 1939

To the Stockholders:

We meet with you again, to discuss the affairs of your company. It gives us pleasure to be able to report to you that the year of 1938 was a year of further progress and achievement for American Airlines, Inc.

EARNINGS FOR THE YEAR:

The operation of the services of the company for the year 1938 resulted in a net profit of $213,261.88, after provision for Income Taxes, as compared with a net loss of $93,627.56 for the year 1937.

TREND OF REVENUE:

	1938	1937	1936	1935
Passenger	$ 7,442,232	$ 6,597,773	$ 5,552,817	$ 3,661,299
Mail	3,331,474	2,982,293	2,444,361	1,999,246
Express	353,617	359,264	227,418	99,719
Other	204,505	131,040	109,495	104,272
Total	$11,331,828	$10,070,370	$ 8,334,091	$ 5,864,536
Passengers Carried	358,295	300,571	255,324	176,005

PASSENGERS:

A new record was established for the number of passengers transported, 358,295 during the year 1938 as compared with 300,571 for the year 1937, an increase of 19.2%. Again in 1938, as in 1937, American Airlines transported more than 30% of the passengers of the domestic air transport industry.

LOAD FACTOR:

In 1938 the company flew a fewer number of airplane miles than in 1937 but served a greater number of passengers, with the result that a greater number of passengers were

transported each mile flown. This is a constructive factor and was one of the principal contributions to the profitable operation in 1938:

	1938	1937
Revenue miles flown	15,314,792	15,597,330
Revenue passengers	358,295	300,571
Average passengers per mile	9.2	7.9
Passenger seat miles flown	254,164,586	242,513,634
Revenue passenger miles	140,869,290	123,074,318
Load factor	55.4%	50.7%

AIR MAIL:

Revenues from the transportation of air mail amounted to $3,331,474.27, as compared with $2,982,292.89 for the year 1937, an increase of 11.7%. Mail pound miles for the year 1938 totalled 3,179,843,792 as compared with 2,805,153,325 for the year 1937, an increase of 13.4%.

AIR EXPRESS:

Revenues from the transportation of air express for the year 1938 amounted to $353,617.00, as compared with $359,264.27 for 1937, a decrease of 1.6%. Substantial increases in air express revenues were shown during each of the last four months of the year, as compared with comparable months in 1937, but these increases were insufficient to overcome the comparable decreases in the earlier months of the year. Although declines were recorded in air express volume, it is noteworthy that the declines in air express were not in proportion to the decline of express volume of other forms of transportation.

OPERATING EXPENSES:

Operating Expenses in 1938 were $11,075,766.13, as compared with $10,296,175.08 for the year 1937. The principal factors which contributed to this increase were:

MAINTENANCE AND OVERHAUL OF AIRCRAFT AND ENGINES: Expenditures for the shop overhaul of aircraft and engines increased in 1938 by the amount of $133,398.46 as compared with 1937, and the expenditures for the daily maintenance of aircraft and engines increased by the amount of $98,854.52, total increase $232,252.98.

Good airplanes, properly maintained by trained mechanics and flown by skilful pilots under policies established by good operating technique are the elements which go to insure a safe operation. The standards maintained by the mechanics of American are high and

the fleet is in excellent condition. The company is committed to the maintenance of these high standards but is well aware of its obligation to operate with the utmost of economy consistent with sound operating practices.

Sales and Advertising Expenses: Expenditures for advertising and sales were maintained in 1938 at the 1937 level of one cent per passenger mile. Total expenditures for sales and advertising for the year amounted to $1,393,607.64, as compared with $1,219,756.49 for the year 1937. Passenger revenues for the year 1938 amounted to $7,-442,231.56, as compared with $6,597,773.42 for the year 1937, an increase of $844,458.14. The advertising policies of the company were the subject of favorable comment by several national publications during the year.

Ground Salaries and Expenses: Ground salaries and expenses for the year 1938 amounted to $2,390,478.11, as compared with $2,267,788.95 for the year 1937. The principal factors contributing to this increase were the establishment and maintenance during the year of higher standards of service to passengers, an increase of 57,724 in the number of passengers served and an increase in compensation paid to employees in this service.

For each airplane crew of three, Captain, First Officer and Stewardess, in the service of the company there are fourteen men on the ground, including flight superintendents, meteorologists, dispatchers, radio operators, weather observers, mechanics and other technicians and agents.

Depreciation and Obsolescence: In the year 1938, $1,548,196.14 was provided for depreciation and obsolescence of equipment and property, as compared with $1,406,293.78 for the year 1937. No changes were made during the year in the basic rates heretofore established for the purpose of providing an adequate reserve for depreciation and obsolescence. The increase in 1938 may be attributed to the fact that the basic value of our aircraft fleet was higher in 1938 than in 1937. Many engineering and technical advances are taking place in the design and construction of aircraft. It is important that the company provide adequate reserves for the factor of obsolescence.

General Payroll: All classifications of expense have been affected by the trend of the general payroll. The payroll for the year 1938 amounted to $4,326,564.00, as compared with $4,148,645.00 for the year of 1937. The average number of employees in the service of the company during 1938 was 1,923, as compared with an average of 1,933 during the year of 1937.

Social Security Taxes: Provisions for all types of Social Security taxes during 1938 amounted to $165,138.88, as compared with $117,371.08 for the year 1937, and $33,327.98 for the year 1936. The increase in 1938 came as the result of increased expenditures

during the year for salaries and wages and as the result of an increased rate for such taxes in 1938 as compared with 1937.

PROFIT PER MILE OF OPERATION:

In 1938 the company earned a profit of $213,261.88, an average profit of $.0139 per mile for the 15,314,792 revenue miles flown.

Based upon this average profit of $.0139 per mile flown, you will be interested in the average profit earned per trip flown on some of the routes operated by the company:

Route	Length of Trip	Average Profit Per Mile Flown	Average Profit Per Trip
Boston to New York	201	$.0139	$ 2.79
New York to Chicago	723	.0139	10.04
Chicago to Fort Worth	924	.0139	12.84
Los Angeles to New York	2,686	.0139	37.34

These figures cannot, of course, be entirely accurate for each trip or route operated during the year, for some trips and some routes were operated with profit and others were operated with loss. The purpose of the figures is to show how very nominal is the profit earned by the company when consideration is given to the millions of miles flown in order to earn that profit.

Based upon these average figures, the company assigned a $120,000 Douglas Flagship, manned by a crew of three, supported by a nationwide field organization, to a flight of 723 miles from New York to Chicago and earned a profit of $10.04 on that operation.

These figures give us every incentive to be more effective in merchandising the outstanding utility of air transportation and give us incentive for the utmost of economy in operation.

FINANCIAL POSITION:

With this report there is included a Balance Sheet, certified to by Arthur Young & Company, giving the financial position of the company as of December 31, 1938.

The equipment obligation to the Reconstruction Finance Corporation, which amounted to $1,426,222.55 on December 31, 1937, had been reduced by December 31, 1938 to $93,035.50, a reduction of $1,333,187.05. These repayments represent a substantial prepayment of amounts due at future dates and no further payments are required on this obligation until October, 1940.

Capital invested in inventory of materials and supplies was materially reduced during the year. As at December 31, 1937, the inventory amounted to $955,992.93, while at

December 31, 1938 it amounted to $569,055.46, a reduction of $386,937.47. This reduction is the result of an intensive program running throughout the year with the purpose of reducing the inventory account to the minimum required for the orderly operation of the business. Large inventories tend to permit the accumulation of obsolete materials and burden the company with writeoffs for their retirement. The objective of a reduced inventory has been easier to attain on account of the fact that the company now operates on all of its routes equipment of the same manufacturer, permitting uniformity in inventory replenishments.

Total capital expenditures made during the year of 1938 amounted to $486,014.37, as compared with $1,757,742.03 in the year 1937 and $3,057,839.24 in the year 1936. Principal capital expenditures made during the year included $200,000.00 for the equipping of our Flagship Fleet with full-feathering, hydromatic propellors, $44,830.00 for small aircraft to be used in pilot training, $52,064.00 for the purchase of additional radio equipment and $114,122.00 for improvements to aircraft and engines.

During 1938, $24,662.50 principal amount of the 5 Year, 4½% Convertible Debentures were converted into 1,973 shares of common stock, increasing the number of shares of common stock outstanding on December 31, 1938 to 290,072. The conversion into shares of a par value of $10.00, at the conversion rate of $12.50 per share, resulted in a credit to Surplus Account of $4,932.50.

CAPITAL STOCK:

At December 31, 1938 the company had authorized 1,000,000 shares of common stock of the par value of $10.00 per share. Of the number authorized:

290,072	shares were issued and outstanding
209,928	shares were reserved for issuance only upon conversion of the presently outstanding $2,624,100.00, 5 Year, 4½% convertible Debentures at the conversion rate of $12.50 per share.
25,000	shares were reserved for issuance under options approved by the stockholders on May 4, 1938 and issued to and held by certain officers and supervisory personnel of the company, the option price being $12.50 per share.
475,000	shares were unissued and unreserved.
1,000,000	Shares

No stock, other than that issued for the conversion of $24,662.50 principal amount 5 Year, 4½% Convertible Debentures, was issued by the company during the year.

EQUIPMENT PURCHASE COMMITMENTS:

Ten additional Douglas Flagships will be delivered to the company during the early part of 1939, five on or about March 1 and five during the month of May. All of these new planes will be 21-passenger craft of the standard Flagship type.

It is not anticipated that additional financing will be required on account of the purchase of this equipment. The company has on hand sufficient funds for full payment for the five aircraft to be delivered in March, $100,000.00 having been prepaid prior to December 31, 1938, and the budget of the company reflects that funds will be available for the payment of the obligation for the second five aircraft at the time of estimated delivery.

OPERATING RECORD:

At December 31, 1938, American Airlines, Inc. had flown its planes 46,895,929 airplane miles and had transported 1,011,697 passengers 410,236,966 passenger miles without an accident involving passenger fatality. On January 14, 1939, the company completed three full years of operation without an accident involving passenger fatality.

CERTIFICATES OF CONVENIENCE AND NECESSITY:

During the year 1938 the Civil Aeronautics Authority was created by the Congress. The legislation which established the Authority provides that the Authority issue certificates of convenience and necessity to the air carriers for the routes and for the types of service rendered by the carriers during a "grandfather" period specified in the legislation.

Hearings have been completed by the Authority on all applications filed by the domestic air carriers under the "grandfather" section of the Act. The examiner's report on the application of American Airlines, Inc. has been submitted to the Authority, recommending the issuance of certificates to American for the routes it operates and it is anticipated that those certificates will shortly be issued.

INEQUITIES IN AIR MAIL COMPENSATION RATES:

We brought to your attention in the Annual Report for the year 1937 certain inequities which existed with respect to the compensation paid to the different transcontinental air carriers for the transportation of mail on their respective transcontinental routes.

The legislation which created the Civil Aeronautics Authority vested it with the authority to review the rates of compensation being paid to air carriers for the transportation of air mail and to make adjustments in such rates if they were found to be inequitable or unreasonable.

The basic rates now being paid for the transportation of air mail on the different routes were established by the Interstate Commerce Commission under authority granted prior to the creation of the Civil Aeronautics Authority.

The existing system provides for the payment to the carrier of a "base" rate of compensation for each mile the mail is transported, for poundage based on monthly averages, the payment of that "base" rate being considered as payment for the transportation of the first 300 pounds of mail so transported. For the transportation of each additional 100 pounds, or fractional part thereof, the carrier is entitled to additional compensation, that compensation being an additional payment per mile equivalent to ten per cent of the "base" payment.

A further collateral factor in determining the exact amount to be paid is whether or not the carrier operates during any one month a number of miles, greater or smaller, than a certain fixed number of miles, termed the "base mileage." For the purpose of the comparisons given in this report "base mileage" is not considered, for it would not, in the cases given, materially alter the results illustrated.

American Airlines, Inc. is one of the three transcontinental air carriers. We give below a comparison of the compensation paid to American for transportation of air mail on its Southern Transcontinental Route and the compensation paid to the other two transcontinental carriers on their respective transcontinental routes:

Route "A"—AMERICAN AIRLINES, INC., operates from coast-to-coast, using Douglas equipment, with two pilots and stewardess, and is paid for the transportation of air mail on its route:

New York-Fort Worth Section:

23c per mile for the first 300 pounds

2.3c per mile for each additional 100 pounds or fractional part thereof, with maximum of 40c per mile.

Fort Worth-Los Angeles Section:

25c per mile for the first 300 pounds

2.5c per mile for each additional 100 pounds or fractional part thereof, with maximum of 40c per mile.

Route "B"—Operates from coast-to-coast, using Douglas equipment, with two pilots and stewardess, and is paid for the transportation of air mail on its route:

30c per mile for the first 300 pounds

3c per mile for each additional 100 pounds or fractional part thereof, with maximum of 40c per mile.

Route "C"—Operates from coast-to-coast, using Douglas equipment, with two pilots and stewardess, and is paid for the transportation of air mail on its route:

31c per mile for the first three hundred pounds

3.1c per mile for each additional 100 pounds or fractional part thereof, with maximum of 40c per mile.

Here are three separate and distinct operations, transporting the same type of mail in the same type of aircraft for the same unit of distance, but being paid four different rates per mile therefor.

A petition has been filed with the Civil Aeronautics Authority seeking an adjustment of this inequitable differential, which primarily affects American Airlines. We are hopeful that some adjustment will result.

FACTORS AFFECTING BUSINESS DURING 1938:

Public confidence is the greatest single factor in the success of air transportation. The industry was blessed with increased public confidence in 1938, and deserved it, for the industry established in 1938 a new record for safety of operation. This increased public confidence resulted in increased patronage of all air lines and it was the greatest single constructive factor during the year.

The student of air transport economics knows that one of the greatest handicaps to economical operation and to the earning of a profit for the year has been the highly seasonal character of the air transport business. The graph of air passenger business by months shows high peaks of business during the summer and fall months with recessions in passenger business during the winter and early spring months.

In American Airlines this curve of peaks and valleys has tended to level out during the past few years and the year of 1938 contributed materially to a further levelling of the curve. This trend is, in our opinion, even more important than the fact that the company was able to operate with profit during the year. Given an opportunity of reducing its losses during certain months of the year, the industry will find it less difficult to show a profit over a twelve month period.

While it is true that actual flight conditions have a direct bearing upon the opportunity to fly and to operate with profit, the trend reflects factors other than weather conditions. People are realizing, more and more that time saved in the winter is as val-

uable as time saved in the summer and they are availing themselves of the utility of air transportation on a more "year around" basis.

While some people have been under the impression that air transportation is less safe in winter than in other seasons of the year, it is interesting to know that industry figures for the full seasons of 1935, 1936 and 1937 show that for those three years the winter months, November through March, recorded fewer air transport accidents and fewer passenger fatalities than did the other months of those years, April through October.

OUTLOOK FOR 1939:

Many constructive factors appear on the horizon for air transportation in 1939. The creation of the Civil Aeronautics Authority establishes the industry on a sounder legislative foundation. The issuance of certificates of convenience and necessity and the future expansion of air transportation on the basis of principles established in the new legislation will contribute to the sound and orderly growth of the industry. The Authority will, we hope, early seek to establish the air mail compensation to the carriers on an equitable basis.

The World's Fair in New York and the Golden Gate International Exposition in San Francisco will stimulate travel and will benefit all forms of transportation. The completion of the new North Beach Airport, near the heart of Manhattan and only one and one-half miles from the World's Fair, will further stimulate air travel in the world's greatest travel market.

It is not anticipated that larger and more expensive aircraft will be in operation on the domestic lines during 1939. That is a constructive factor, for, while it has been demonstrated that profitable operation is possible with the present modern equipment, we cannot be sure that there is available a sufficient volume of business to operate larger and more expensive flying equipment at a profit. There are many empty seats in the present aircraft which should be sold before larger aircraft are acquired.

The industry will continue to advance, and new and more modern aircraft will be developed, built and operated, but the managements of all of the airlines have an obligation to their stockholders to utilize well the equipment they now own before accelerating its obsolescence by acquiring other types.

All of the airlines have been burdened by the necessity of providing large reserves for obsolescence of aircraft. In years of unprofitable operation these reserves have had to come from capital, not earnings. At least until the industry is able to absorb in operating expenses, without loss, the reasonable charges for obsolescence, the members of the industry should not contribute to factors which will further accelerate that rate of obsolescence.

Air travel is largely business travel and our business will be directly affected by the level of general business conditions prevailing in the country in 1939.

THE ORGANIZATION:

The most valuable asset of American Airlines is not recorded on the books of the company—it is the 2,000 men and women who are devoting their lives to air transportation and to American Airlines. The records to which we point with pride are their achievements. They do their work modestly and well and they are determined to continue that good work. They each have our sincere appreciation.

WE NEED THE AID OF OUR STOCKHOLDERS:

Each year we have asked your aid in further increasing the business and prestige of American Airlines. Our company can maintain its position of leadership in the industry only by the combined efforts of us all. Do your part in 1939 to encourage your friends and associates to Fly With the Flagship Fleet.

Respectfully submitted,

President.

CONSOLIDATED BALANCE

ASSETS

Current Assets:			
Cash in banks and on hand			$ 959,047.25
Accounts receivable—			
United States Government Departments		$ 461,663.71	
Other airline companies and agents—traffic and express balances, etc.		93,067.26	
Other trade		270,740.89	
		$ 825,471.86	
Less: Reserve for doubtful accounts		12,633.30	
			812,838.56
Inventories—Physical inventories of parts and supplies valued at the lower of cost or market			569,055.46
Indebtedness of officers and employes			5,222.21
Total Current Assets			$2,346,163.48
Special Funds:			
United States Treasury notes—			
Deposited in connection with insurance indemnity agreement—quoted value $61,566.54		$ 59,974.25	
Cash—			
Deposited in connection with lease agreement	$ 28,000.00		
Deposited to apply against purchase price of airplanes on order	100,000.00	128,000.00	
			187,974.25
Flying Equipment, at Cost		$5,069,546.80	
Less: Reserve for obsolescence and depreciation		3,150,412.15	
			1,919,134.65
Land, Buildings and other Equipment, at Cost		$2,406,273.32	
Less: Reserve for depreciation		1,081,214.63	
			1,325,058.69
Miscellaneous Physical Property not in use, at Estimated Realizable Value			189,228.61
Deferred Charges:			
Prepaid rents and insurance		$ 44,682.75	
Other deferred charges		34,530.35	
			79,213.10
			$6,046,772.78

NOTES:

1. Contingent liability: Under pending litigation—claims, not covered by insurance, do not exceed $5,000.00.
2. Officers and executives have options expiring July 1, 1941 for the purchase of 25,000 shares of capital stock, $10 par value, at the price of $12.50 per share, when and if the optioned stock is registered under the Securities Act of 1933 and the Securities and Exchange Act of 1934 and listed on the New York Curb Exchange. Such options are exercisable to the extent of one-third of above

SHEET — DECEMBER 31, 1938

LIABILITIES

CURRENT LIABILITIES:			
Notes payable, due November 30, 1939		$ 60,375.00	
Accounts payable and accrued expenses		575,715.66	
Accrued interest		1,869.78	
Accrued social security taxes		60,723.44	
Accrued miscellaneous federal, state and local taxes		18,520.90	
Provision for federal income taxes		42,800.00	
			$ 760,004.78
DEPOSITS ON AIR TRAVEL PLANS AND UNREDEEMED TRAVEL SCRIP			648,370.97
LONG TERM DEBT:			
5% chattel mortgage notes, Reconstruction Finance Corporation, due 1940		$ 93,035.50	
Secured by chattel mortgage on aircraft and equipment of a cost of approximately $3,091,000			
Five year 4½% debentures, due July 1, 1941—			
Convertible	$2,624,100.00		
Non-convertible	872,187.50		
		$3,496,287.50	
			3,589,323.00
CAPITAL STOCK:			
Authorized—1,000,000 shares, par value $10 per share			
Reserved for conversion of five year 4½% debentures—209,928 shares (conversion price $12.50 per share)			
Issued—290,072 shares			2,900,720.00
SURPLUS:			
Paid-in surplus—			
Arising from the conversion of $153,712.50 principal amount of five year 4½% convertible debentures into 12,297 shares of common stock, par value $10 per share at the conversion price of $12.50 per share		$ 30,742.50	
Earned surplus (deficit)—			
Balance, December 31, 1937	*$2,095,650.35*		
Net profit for year ended December 31, 1938	213,261.88		
		1,882,388.47	
			1,851,645.97
			$6,046,772.78

amount on or before July 1, 1939; additional one-third on or before July 1, 1940 and balance on or before July 1, 1941. Option may be exercised in full at end of option period, providing officer or executive is still in employ of company.

3. There are commitments for the purchase of aircraft for delivery in 1939 amounting to approximately $1,140,000.00.

Consolidated Statement of Profit and Loss
For the Year Ended December 31, 1938

OPERATING REVENUE:		
Passenger	$7,442,231.56	
Mail	3,331,474.27	
Express	353,617.00	
Other (net)	204,505.18	
Total operating revenue		$11,331,828.01
OPERATING EXPENSES:		
Flying	$4,926,874.89	
Ground	2,390,478.11	
Sales	790,541.06	
Advertising and publicity	603,066.58	
General and administrative	366,797.18	
Total operating expenses exclusive of depreciation		9,077,757.82
		$ 2,254,070.19
OTHER INCOME:		
Profit on sale of property and equipment	$ 1,806.54	
Other	37,607.58	
		39,414.12
		$ 2,293,484.31
OTHER CHARGES:		
Interest on long-term debt	$ 199,733.19	
Loss on liquidation of obsolete inventories	61,125.28	
Social security and general taxes (other than taxes included in operating expenses)	196,791.98	
Other	31,575.84	
		489,226.29
NET PROFIT BEFORE PROVISION FOR OBSOLESCENCE, DEPRECIATION AND FEDERAL INCOME TAXES		$ 1,804,258.02
PROVISION FOR OBSOLESCENCE AND DEPRECIATION		1,548,196.14
		$ 256,061.88
PROVISION FOR FEDERAL INCOME TAXES		42,800.00
NET PROFIT CARRIED TO SURPLUS		$ 213,261.88

ARTHUR YOUNG & COMPANY
ACCOUNTANTS AND AUDITORS
1 NORTH LA SALLE STREET
CHICAGO

February 28, 1939.

To the Board of Directors,
American Airlines, Inc.

We have made an examination of the consolidated balance sheet of American Airlines, Inc. and subsidiary companies as at December 31, 1938 and of the consolidated statement of profit and loss for the year ended that date. In connection therewith we examined or tested accounting records of the companies and other supporting evidence and obtained information and explanations from officers and employes of the companies; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

In our opinion, based upon such examination, the accompanying consolidated balance sheet and related consolidated statement of profit and loss fairly present, in accordance with accepted principles of accounting consistently maintained by the companies during the year under review, their consolidated position at December 31, 1938 and the results of consolidated operations for the year ended that date.

ARTHUR YOUNG & CO.,
Certified Public Accountants.